

INSURANCE COMMISSIONER'S COMMENTS ON THE OPERATIONAL REVIEW OF THE STATE COMPENSATION INSURANCE FUND

INTRODUCTION

The State Compensation Insurance Fund (SCIF) was created by the California Legislature in 1914 to assure California employers of the availability of workers' compensation coverage at the lowest possible cost. This was done concurrently with the enactment of the first compulsory workers' compensation laws in California.

The law provides that SCIF must compete fairly with other insurers and must be no more and no less than self-supporting. The Insurance Commissioner is charged with ensuring that SCIF operates lawfully and in a manner that that is not hazardous to its policyholders, injured workers, creditors, or the public.

Today, SCIF is California's largest writer of workers' compensation insurance and serves as the state's insurer of last resort for workers' compensation insurance. In 2003, SCIF had almost 53% of California's workers' compensation market share. As reforms have taken effect and competition has increased, SCIF's market share is now approximately 23%.

On March 28, 2007, amid serious questions regarding the corporate governance and management of the organization following the removal from office of its President and a Vice-President by the Board of Directors, I ordered an independent top-to-bottom operational review of SCIF. I directed that the review include all significant aspects of the organization and its governance.

In addition, I also recommended that SCIF make the following structural and operational changes:

1. Establish an audit committee comprised exclusively of Board Members to oversee internal and external audit functions to ensure the integrity of the Fund's financial statements, internal controls, compliance with legal and regulatory requirements, and address the findings of internal and external audits.
2. Transfer internal audit oversight to the Board of Directors or a Board-administered independent audit committee.
3. Immediately establish four positions: (1) Chief Financial Officer and (2) Chief Investment Officer (3) Chief Operating Officer and (4) Chief Information Officer.

4. Limit the General Counsel's responsibilities solely to legal services to maintain objectivity and avoid potential conflicts of interest.
5. Immediately dismiss or place on administrative leave any member of SCIF's management team who knew of, or by virtue of job duties should have known of, improper payments being made by SCIF.
6. Adopt a clear Conflict of Interest policy and a Code of Ethics for both Board members and management staff.

On May 18, 2007, I appointed RSM McGladrey, Inc. (RSM McGladrey) to conduct an operational review of SCIF. In addition, I directed the Department's Enforcement Branch to investigate potential criminal wrongdoing associated with the activities that led to the terminations. Subsequently, the Department's investigation was merged into a joint effort with the California Highway Patrol and the San Francisco District Attorney's. To protect the confidentiality of this on-going criminal investigation, it will not be addressed in this report.

THE OPERATIONAL REVIEW

The operational review conducted by RSM McGladrey focused on the following areas:

- Governance and Management Practices
- Group Association Program
- Information Technology (IT)
- District Offices and Claims Processing Centers
- Business Services

RSM McGladrey completed its review and submitted its findings in a draft report dated October 31, 2007. The major findings from this report are summarized below.

KEY FINDINGS

Governance and Management Practices

The SCIF Board of Directors is too small and lacks sufficient resources to provide the degree of oversight for an insurer of SCIF's size and complexity. The Board needs detailed procedures to eliminate conflicts of interest, and there should be both minimum qualifications and additional compensation for Board members. This combination of factors resulted in both minimal operational oversight and many of the operating deficiencies cited here and in the full report.

Additionally, SCIF lacks a solid management structure. Many key positions that exist in organizations of similar size and complexity are completely lacking. For example, SCIF has no Chief Financial Officer, Chief Investment Officer, Chief Information Officer or Chief Operating Officer.

Group Association Program

SCIF provides policyholders the ability to join a variety of industry associations throughout California. As a result, SCIF's group policyholders receive a six percent discount on premiums and the associations are paid an administrative fee by SCIF for their services. The administrative fee is based on a percentage of the premium generated by the association.

Oversight of the group administration fees has been severely inadequate. Prior to 2007, group contracts did not require specific services to be provided. As a result, tremendous inconsistencies existed in the number and quality of services performed. In some cases, little to no safety services, or any other services, were provided to the members of the associations being paid these administrative fees. Although the standard contracts authorized SCIF to audit the use of these fees, no audits were ever performed. Further, despite the magnitude of these expenses, these agreements did not require Board approval.

Our review found that SCIF paid in excess of \$500 million in group association administration fees from 1997 through January 2007. Of this amount, over \$140 million was paid to an entity controlled by a person who was a board member from 2003 through 2006. In addition, over \$125 million was paid to associations with whom another member of the Board from 2004 through 2006 had a business affiliation.

Group administrative fees paid to associations were incorrectly classified as legal and auditing fees in financial statements. This classification was misleading to users of the financial statements. These fees should be booked as a write-in line.

Information Technology (IT)

SCIF's IT policies and procedures are fragmented and several key policies have not been approved by senior management. These deficiencies limit the effectiveness of IT governance. For example, SCIF lacks a detailed plan to migrate its data to a centralized location.

SCIF has had excessive reliance on IT vendors. Since 2004, it has paid IT vendors approximately \$321 million. Between 2003 and 2006, payments made to just two of these vendors totaled approximately \$43 million. Payments made from 1996 to 2006 to these two vendors, and affiliated companies, totaled almost \$100 million. In September

2007, SCIF filed suit against these two IT vendors for, among other charges, breach of contract.

IT security is vulnerable because the Enterprise Security Group (the unit charged with security) does not have system-wide authority. As a result, critical events or actions relating to system security can go undetected. Further, the segregation of these duties can compromise data integrity.

It should also be noted that previous audits by Ernst & Young, KPMG and SCIF's internal audit team all identified valid IT control weaknesses that have not been addressed for more than a year.

District Offices and Claims Processing Centers

Earlier this year, SCIF transferred responsibility of bill payments to three claims processing centers. This has proven problematic. Since this transition, medical and indemnity late-paid bill penalties have increased significantly. From January-July 2007, SCIF paid \$19.5 million in penalties for delayed processing of medical and indemnity claims. These delays were the result (at least in part) of staffing cuts made against the recommendation of the SCIF Board Chair and/or the Vice President who had assumed management of these facilities.

Business Services

SCIF maintains a fleet of 2,000 vehicles for its 8,000 employees. In spite of the significant cost of acquisition and maintenance of this vehicle fleet, SCIF has not performed an audit of Fleet Management since 2003, and the 2008 approved Internal Audit plan does not include a review of Fleet Management. An analysis of the need for fleet vehicles should be considered to determine whether all of the vehicles owned or leased by SCIF are necessary.

SCIF engaged in inappropriate business practices that allowed additional expenditures to be made to vendors which were outside of the Board approved budgetary process. This practice allowed SCIF to purchase goods or services, and make charitable contributions, which were neither known nor approved by the Board.

RECOMMENDATIONS

Governance and Management Practices

A number of significant changes should be made to the SCIF Board of Directors and Executive Management.

- The size of the Board should be expanded;
- Board terms and qualifications should be reviewed and revised;
- Board representation should include investment and legal experts;
- Policies should be established to clearly eliminate potential conflicts of interest;
- Serious consideration should be given to re-evaluating Board compensation.

SCIF should develop, and its Board should approve, a training curriculum for Board members that includes corporate governance and ethics. Board members should participate in annual education sessions related to trends in the workers' compensation market.

The Board should create committees to facilitate more effective and efficient management. While an audit committee was formed earlier this year, it is essential that budget, governance and compensation committees also be formed.

SCIF should adopt a corporate governance framework that provides for effective internal controls. The revised NAIC Model Audit Rule or the Sarbanes-Oxley Act of 2002 may serve as guides in the development of internal controls over financial reporting.

SCIF should create four key senior management positions: Chief Operating Officer; Chief Financial Officer; Chief Information Officer; and Chief Investment Officer. SCIF should petition the legislature for additional exempt positions to address this deficiency.

- A Chief Operating Officer would oversee day-to-day operations, and allow the President and Chief Executive Officer to focus on long-term strategy.
- The Chief Financial Officer should oversee all financial operations and reporting. Because SCIF has no one individual currently fulfilling this responsibility, the work is divided between two consultants – both of whom are scheduled to leave by the end of 2007. This temporary and divided structure has created numerous control and reporting problems.
- The Chief Information Officer should oversee all information technology functions. The lack of a person with sufficient technical expertise in charge of IT operations at SCIF has resulted in the numerous internal control deficiencies uncovered during our review.
- The Chief Investment Officer should administer SCIF's investment activities, which include striking a balance between the competing objectives of maximizing investment yield while ensuring timely payment of amounts owed. SCIF currently contracts out the responsibility for investment decisions. This is not

prudent policy for a company with an investment portfolio in excess of \$22 billion.

SCIF must be granted greater flexibility to compensate the above positions. The current salary structure for senior management positions does not allow SCIF to compete with other firms to attract the most qualified individuals. It is important that duties for these executives are properly outlined.

Other exempt positions may be needed as SCIF reorganizes other functions and enhances controls within the organization.

Group Association Program

A number of actions should be taken with regard to restructuring the group association program including:

- Develop policies to eliminate potential conflicts of interests in the administration of the group policies;
- Take steps to ensure that administrative fees paid to group associations are commensurate with the fair value of the services rendered; Conduct annual audits to ensure contract compliance; SCIF should ensure that services rendered do not constitute the transaction of insurance unless the association holds a license to transact insurance.
- Develop stricter underwriting guidelines for the association programs that will verify group association membership eligibility.
- Correctly classify group administrative fee payments in financial statements.

Information Technology

SCIF should engage an outside consultant to help oversee IT until a permanent Chief Information Officer position is established and filled.

All IT related policies should be updated and submitted for senior management approval. Areas covered should include:

- network policy
- access control
- application security
- communication protocols between the district and home office

The contracts and expense budgets for the Vacaville Data Center project should be reviewed by the Board and/or financial experts to assess the level of accuracy of assumptions in the budget for each phase. The budgets for the data center migration costs should be documented in more detail to ensure that expense calculations like project

supervision, decommissioning of old data centers and engagement of consultants can be analyzed.

The role of the Enterprise Security Department should be evaluated in order to permit the security group to act as an enforcer of the State Fund's IT policies. Security best practices should also be integrated into the IT policies on an enterprise wide basis.

District Offices and Claims Processing Centers

Action must be taken to address the problems that have caused a significant increase in medical bill penalties after the medical bill payment function for all district offices was transferred to three claims processing centers.

Business Services

An internal audit of the fleet car pool should be performed and a separate analysis may need to be performed to assess the necessity for all of these vehicles.

Expenditures should be made in line with a Board approved budget and invoices should fully document specific services provided.

CONCLUSION

SCIF recognizes the need for changes in both its operations and management – and they have already begun this process. The arrival of a permanent president and filling board vacancies are a positive change. Much remains to be done, and I look forward to continued diligence and cooperation from SCIF and its leadership as we work to ensure an excellent organization.